

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

There can be no mincing words. The preferred market had an awful year. As the table demonstrates, the environment has been extremely difficult for PFD, which must invest most of its assets in preferred securities and which utilizes leverage to achieve its goal of producing a high level of current income. The most positive thing we can say about these numbers stems from our fervent belief that, at present, preferred securities prices have simply fallen too much, and, over time, will recover.

### TOTAL RETURN ON NET ASSET VALUE<sup>(1)</sup> FOR PERIODS ENDED NOVEMBER 30, 2008

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(2)</sup>
Flaherty & Crumrine Preferred Income Fund . . . . .	-33.9%	-43.3%	-48.8%	-20.9%	-11.2%	-1.8%	5.3%
Lipper Domestic Investment Grade Funds <sup>(3)</sup> . . . . .	-15.2%	-17.1%	-17.6%	-2.8%	0.2%	3.4%	5.8%

(1) Based on monthly data provided by Lipper Inc. in each calendar month during the relevant period. Distributions are assumed to be reinvested at NAV in accordance with Lipper's practice, which differs from the methodology used elsewhere in this report.

(2) Since inception on January 31, 1991.

(3) Reflects the equally-weighted average performance returns of all closed-end funds in Lipper's Domestic Investment-Grade funds category in each month during the period. The category currently includes closed-end funds in the U.S. Mortgage and Corporate Debt BBB Rated sub-categories and has included other sub-categories in prior periods. Although the investment strategies used by the Fund differ significantly from the strategies used by these other fixed-income funds, the Fund seeks to accomplish a similar objective.

We encourage you to read the "Discussion Topics" that follow for a more thorough analysis of the Fund's investment performance. We've also included the performance of several preferred market indices for further comparison.

Once more we struggle to find appropriate words to describe events in the financial markets. Although evidence of market troubles first appeared in mid-2007, there can be little doubt that in recent months we have witnessed the worst fallout from the financial crisis. Over a ten day period in September, the government placed Fannie Mae and Freddie Mac into conservatorship, Lehman Brothers filed for bankruptcy and AIG required the first of two massive doses of government assistance. Like a financial earthquake, these events sent tremors throughout the financial system, with the preferred market situated near the epicenter.

In response, the Federal Reserve has flooded the system with liquidity, and numerous new government programs designed to stabilize the financial system have been created. The critical objective of each program is to restore confidence in the system, and to that end no amount of effort (or money) has been spared. Many of these efforts appear to be taking hold, and while we are clearly in the midst of a severe economic slowdown, the foundation for recovery is being established.

Of these government programs, the Capital Purchase Program (“CPP”) launched in mid-October had the greatest significance for the Fund. Through this program, the government injected almost \$350 billion of capital into qualifying banks and finance companies by purchasing newly issued preferred securities. The preferred market got a boost when it was disclosed that *existing* preferred securities of companies that participate in the program will typically *rank equal or senior* to those held by the government.

Most of the new government programs are aimed at shoring up the financial industry (commercial banks, investment banks and insurance companies). Despite having disproportionately less exposure to financials when compared to the overall preferred universe<sup>1</sup>, the Fund’s performance has been hurt badly by the industry downturn. At their lowest levels, prices on some financial issues had fallen by over 75%. Once the lifeline of government aid reaches a particular company, prices on its securities tend to rebound, but they remain well below earlier levels. Of the 22 bank and finance companies owned in the Fund, 16 have received government assistance or have been acquired by stronger institutions.

Much of the price decline can be attributed to concerns about credit quality, but as we’ve discussed in the past, technical factors like the ongoing massive, economy-wide deleveraging and a dramatic decline in market liquidity have hurt valuations as well. Issues of utility and energy companies, which comprise most of the non-financial portion of the portfolio, also experienced substantial price declines during the period. While concerns about credit quality may have contributed to these price declines, technical factors have played a major role.

Market conditions have made it necessary to reduce the amount of leverage employed by the Fund. As the value of the Fund’s investment portfolio declined, the ratio of assets to liabilities fell below required levels. The only remedy has been to redeem a portion of the leverage. To date the Fund has redeemed 31.5%, or \$25.2 million, of the leverage in place at the beginning of the year. Leverage is critical for enabling the Fund to achieve its goal of providing high current income – we encourage you to carefully read the discussion topics that follow.

An unavoidable consequence of deleveraging has been a reduction in the amount of income available to shareholders in the form of monthly dividends. Simply put, the Fund sold assets in order to redeem leverage, and fewer assets mean less income generated. Since the beginning of fiscal 2008, market conditions have required us to reduce the monthly dividend several times, for a total reduction of 26.7%. Again, this important topic is addressed more fully in the discussion topics.

The unprecedented turbulence in financial markets also prompted the Fund to modify its interest-rate hedging strategy this year. As the credit crisis intensified in 2008, the normal relationship between the prices of preferred securities and the Fund’s interest rate hedge positions (primarily options on Treasury bond futures and interest rate swaps) weakened or even reversed, so that the hedge could not be used effectively

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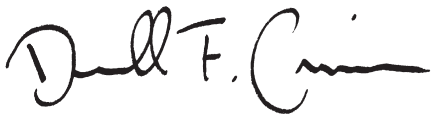
<sup>1</sup> According to the Flaherty & Crumrine website, [www.preferredstockguide.com](http://www.preferredstockguide.com), preferred securities issued by financial companies comprise 85% of the face value of the overall preferred market. As of November 30, 2008, 53% of the market value of PFD’s portfolio was in financials.

to help stabilize the Fund's NAV. At the same time, the yield curve steepened and option prices rose, increasing the cost of hedging. As these conditions developed, the Fund scaled back its interest rate hedge positions, removing them entirely by the end of 2008. We continue to review the effectiveness of the Fund's hedging strategies, and we anticipate using some hedging instruments when we believe it can accomplish its goals. For the most part, that means markets returning to more normal relationships. We don't know when that day will come, but we remain confident that it will.

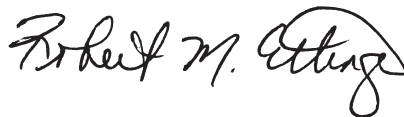
Where do we go from here? Just about any fixed-income investment that doesn't have "US Treasury" in its name has likely declined substantially in price over recent months, but the market for preferred securities has been particularly hard hit. Price declines of 50-75% on investment grade preferreds have not been unusual. We believe the preferred market is significantly undervalued at this time and that long-term investors will be rewarded handsomely for their patience. This conclusion is based upon our analysis described in the discussion topics and on the Fund's website.

Finally, we know this has been an extremely difficult year for shareholders, and while we might like to say we have been here before, we can't because we haven't. We believe that our fundamental approach to portfolio management has helped us avoid most of the credit casualties (the biggest exception being our exposure to Lehman Brothers Holdings). We also believe the current portfolio is comprised of survivors. The steps taken by the Fed and Treasury are starting to gain traction and will help. Economic downturns are always followed by recoveries and the incoming administration has indicated that stabilizing the economy is its highest priority. Although we cannot say exactly when the preferred market will recover, we look forward to a much happier 2009!

Sincerely,



Donald F. Crumrine  
Chairman of the Board



Robert M. Ettinger  
President

January 13, 2009

## DISCUSSION TOPICS

### The Fund's Preferred Securities Portfolio and Components of Total Return on NAV

It's pretty safe to say the preferred securities market suffered its worst year in history in 2008. While no index comprehensively reflects the preferred market, Merrill Lynch publishes four different indices which attempt to measure performance of some sectors of the investment-grade preferred securities market: the Merrill Lynch 8% Capped DRD Preferred Stock Index (which includes traditional tax-advantaged preferred stocks); the Merrill Lynch 8% Capped Hybrid Preferred Securities Index (which includes fully-taxable, exchange-traded preferred securities); the Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index (which includes fully taxable capital securities); and the Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index (which includes both tax-advantaged and taxable preferred securities with adjustable dividends). Set forth below are the six month and twelve month total returns of these indices:

#### Total Returns of Merrill Lynch Preferred Securities Indices\* for Periods Ended November 30, 2008

	<i>Six Months</i>	<i>One Year</i>
Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	-41.5%	-41.9%
Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	-25.7%	-21.9%
Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> ....	-32.2%	-35.9%
Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	-51.4%	-54.4%

\* The Merrill Lynch 8% Capped DRD Preferred Index<sup>SM</sup> includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividends received deduction with issuer concentration capped at a maximum of 8%. The Merrill Lynch 8% Capped Hybrid Preferred Index<sup>SM</sup> includes taxable, fixed-rate, U.S. dollar-denominated investment-grade, preferred securities listed on a U.S. exchange with issuer concentration capped at 8%. The Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index<sup>SM</sup> includes investment grade fixed rate or fixed-to-floating rate \$1,000 par securities that receive some degree of equity credit from the rating agencies or their regulators with issuer concentration capped at a maximum of 8%. The Merrill Lynch 7% Capped Adjustable Rate Preferred Securities Index<sup>SM</sup> includes adjustable rate preferred securities issued by US corporations and government agencies with issuer concentration capped at a maximum of 7%. All index returns include interest and dividend income and, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

While we realize it's only small consolation, as set forth in the table below, the Fund's total return on its securities portfolio before leverage exceeded most of these indices. Unfortunately, the Fund's strategy of using leverage to increase current income amplified its negative returns, and coupled with its expenses and hedging strategy, caused the NAV of the Fund to underperform most of the unleveraged indices.

The table below reflects performance of each investment tool used by the Fund to achieve its objective, namely: (a) investing in a portfolio of securities; (b) hedging that portfolio of securities against significant increases in long-term interest rates; and (c) issuing an auction-rate preferred stock to leverage and enhance returns to Common Stock shareholders. The table then adjusts for the impact of the Fund's operating expenses to arrive at a total return on NAV (which factors in all of these items).

**Components of PFD's Total Return on NAV  
for Periods Ended November 30, 2008**

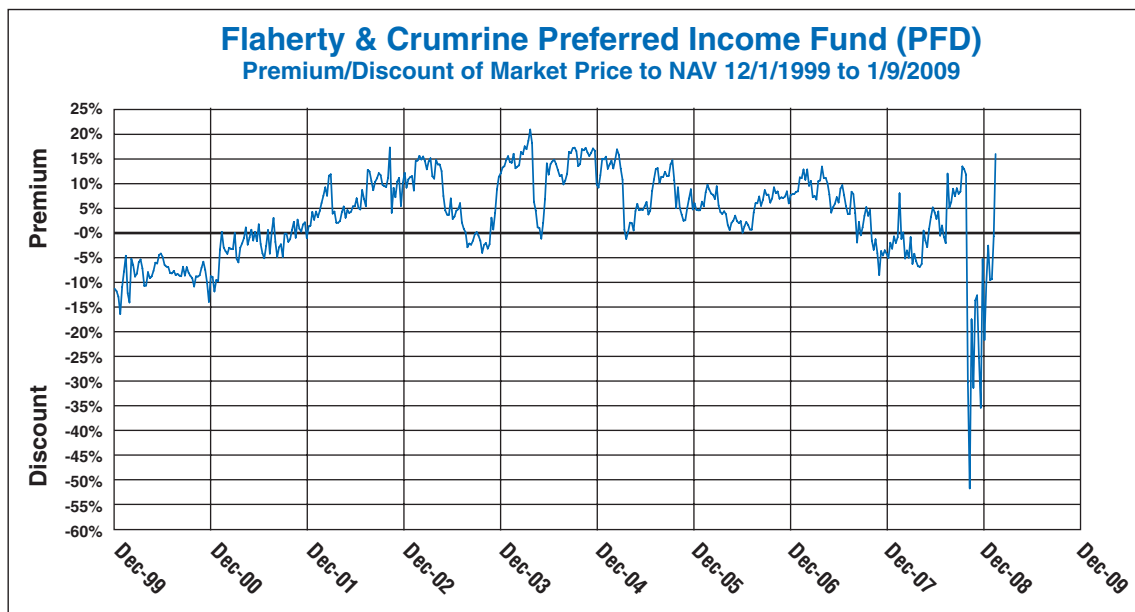
	<i>Six Months</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal and income) .....	-24.3%	-27.7%
Return from Interest Rate Hedging Strategy .....	-0.5%	-0.4%
Impact of Leverage .....	-17.5%	-18.7%
Expenses.....	-1.0%	-2.0%
<i>Total Return on NAV.....</i>	<i>-43.3%</i>	<i>-48.8%</i>

**Total Return on Market Price of Fund Shares**

While our focus is primarily on managing the Fund's portfolio, an investor's actual return is comprised of monthly dividend payments plus changes in the Fund's market price. The loss-of-confidence factors that hurt prices of securities in the Fund's portfolio also caused selling of shares of the Fund itself that widened the Fund's market-price discount to NAV. This double negative resulted in a total return on market value for the year ended November 30, 2008 of -49.3%. During the fourth fiscal quarter alone, total return on *market value* was -41.5%.

Of course, the factors impacting prices of securities in the Fund's portfolio also drove down the price of the Fund. The market price hit a low of \$2.82 on October 10<sup>th</sup>. As of December 31<sup>st</sup>, subsequent to the Fund's fiscal year end the price had recovered some, closing the calendar year at \$5.90.

As can be seen from the chart below, the gap between the price of the Fund and the intrinsic value of the Fund (NAV) reached its widest level ever during October. No surprise, the record discount coincided with share price closing lows.



We have often observed year-end selling pressure in the Fund as investors attempt to realize gains or losses for tax purposes. Given the sharp decline in the Fund's price, this year appeared to be no different. We were heartened to see some price recovery in December, which probably means the Fund's high current yield on market price, 12.8% as of December 31<sup>st</sup>, has attracted new investors.

### **Monthly Distributions to Fund Shareholders**

The monthly distribution paid to shareholders is intended to reflect current market conditions, but we also must make assumptions about the future. We begin with an estimate of the sustainable income generated from the investment portfolio, and end with a forecast of expenses. While it sounds simple, in periods of rapid change, forecasting income and expenses becomes more art than science. As a result, the monthly dividend rate changed several times this year. A portion of the distributions in calendar year 2008 were classified as a tax return of capital rather than ordinary income.

Since the beginning of fiscal 2008, the monthly dividend has been reduced from \$0.086 to \$0.063. Most of the dividend reduction in 2008 can be attributed to deleveraging. The reasons for deleveraging are discussed in detail below, but the impact on the Fund's monthly dividend is fairly obvious – in order to redeem or purchase a portion of its outstanding leverage, the Fund had to sell assets. As a result, the smaller portfolio generated less income; and while a smaller leverage balance helped reduce expenses, the net result was less income available to common shareholders.

### **The Fund's Leverage**

Let's start with, "Why does the Fund use leverage?" The answer is that the cost of leverage typically is lower than the yield on the Fund's portfolio and provides a valuable net addition to income for common shareholders. Since the Fund's inception, Auction Preferred Stock ("APS") has been the most effective form of leverage for a fund such as PFD, and an integral component of the Fund's income objective. However, earlier this year the auction process became a casualty of the liquidity crisis, and by February auctions were "failing". (This unfortunate terminology is used when there are not enough new investors to absorb the shares available for sale at or below the issue's maximum dividend rate. It should not be confused with a default by the issuer.)

Each issue of APS specifies how the rate will be determined when an auction fails. In the case of PFD, if an auction fails, the rate is set at the higher of the 60 day non-financial commercial paper index plus 2.5%, or that same index times 1.75. Since February, the rates paid by the Fund have been determined in this manner.

Fortunately, as Federal Reserve efforts to lower short-term interest rates (including the benchmark commercial paper index) have finally started to work, rates being paid by the Fund have dropped as well, and are now well below where they were a year ago.

Until recently, changes to the *amount* of leverage have been rare. However, during the last fiscal quarter the Fund redeemed \$25.2 million of its APS. As of November 30, 2008, PFD had \$54.8 million in auction preferred stock outstanding. The overall percent leverage represented by auction preferred stock to the Fund's total net assets available to common and preferred as of the same date was approximately 46.4%, reflecting the redemptions during the quarter (footnote 6 of the financial statements shows the details of these redemptions).

When the Fund was created, certain requirements designed to protect the interest of APS investors were established. Among these, the Fund must meet certain asset coverage requirements. Essentially, this calculation compares the Fund's asset values (discounted according to a specific set of rules) to the liquidation value of the APS plus the Fund's other liabilities. If this discounted asset value does not meet or exceed this amount, the Fund may not set aside, declare or pay dividends to common stock shareholders, and it must take steps to "cure" this coverage test. To do so, the Fund may adjust holdings (certain assets receive better asset coverage treatment than others) and sell assets to raise cash. Proceeds from asset sales may be invested in higher quality, lower yielding securities or held in cash, or in some cases used to reduce leverage, to restore the required level of asset coverage. If market values continue to decline, additional sales may be needed. If asset values move higher, the asset coverage will improve and additional asset sales will not be required.

If the Fund fails to meet this asset coverage test for ten business days, it is required to declare its intention to redeem at least enough shares of APS to once again pass the test (if you can't raise the bridge, you must lower the water). In addition, the Fund has the *option* of redeeming APS on any given auction date (which recur every 49 days) or purchasing shares directly from APS holders in private transactions.

In order to pay common stock dividends, the Fund must also meet certain requirements under the Investment Company Act of 1940. Among other things, the Act requires the Fund to have at least 200% asset coverage for its APS before it may declare a dividend to be paid to common stock shareholders. In other words, before declaring its dividend, a Fund has to have at least \$2 of assets for every \$1 of APS outstanding.

While we were able to make significant progress in meeting the asset coverage tests by changing the composition of the portfolio, the Fund was forced to conduct mandatory redemptions in November. In addition, the Board of Directors of the Fund determined to further de-leverage through optional redemptions and share repurchases.

We continue to explore alternatives to the APS, including debt financing. We want to be certain that any new type of leverage is consistent with the Fund's long term objectives. In the meantime, and importantly, the rates being paid on remaining APS have declined, along with other short-term interest rates, and still provide meaningful benefits to the dividend paid to common shareholders.

## **Preferred Market Conditions**

As we've mentioned, prices on almost all preferred securities are down in recent months, and in some instances the declines are hard to fathom. Traditional valuation techniques have not been very useful in this environment, but one tool that helps frame the discussion is called *default tolerance*.

We've posted a thorough discussion of our analysis on the Fund's website under the heading *Preferred Valuation After the TARP*, and we encourage shareholders to check it out. For our purposes here, a summary will suffice.

The objective of the analysis is to answer the question "*Given current valuations, what percentage of the portfolio would have to default to leave you worse off than buying a ten-year US Treasury note?*" As with any model, there are assumptions made, but even with conservative assumptions, over the ten years beginning December 31, 2008, 48% of the Fund's current portfolio would have to default in order for the Treasury note to produce a better return. This is an extraordinarily high default rate.

Looking rationally at preferred securities valuation leads us to the firm conclusion that preferreds are cheap. They are at historically wide spreads to benchmark fixed-income asset classes. They can tolerate very high default rates and still generate positive returns, and the government's actions to limit the severity of the recession should substantially reduce the risk that defaults get that severe. At more-reasonable default rates, preferreds can provide common equity-like returns with lower risk. We believe that preferred securities remain extremely attractive for long-term investors.

However, we recognize that markets today are far from completely rational. Stung by losses, some leveraged preferred investors have been forced to exit the market, and many will not come back. Others see short-term risk that they feel outweighs preferreds' long-term potential, or they fear that new issue supply will prevent preferreds from recovering. Still others genuinely fear that the U.S. economy is headed for another Great Depression, despite all efforts to prevent it.

We do not know precisely how this recession will play itself out. We can only assess the factors that we think will affect preferred valuation and act accordingly. All investing entails taking risks. Intelligent long-term investing entails taking risks when the potential payoffs are high and the probability of poor outcomes is low. We believe that in the preferred market, now is such a time.

Although all companies have felt some strain from the recession and credit crunch, banks, finance companies, broker-dealers and, more recently, insurance companies have been most affected, given their direct and indirect exposure initially to the problems in housing and subsequently to financial markets. The pressure on preferred security valuations, especially those of financial issuers, intensified in early September with the federal government taking conservatorship of Fannie Mae and Freddie Mac (the GSEs), investing at a position senior to existing preferred holders and suspending the payment of preferred dividends. This proved a major catalyst for the collapse of preferred valuations (most dramatically for DRD eligible issues) beginning in September. These developments were closely followed by the bankruptcy of Lehman Brothers Holdings and the rescue of AIG. The surviving major broker-dealers reacted accordingly, with Merrill Lynch arranging a quick marriage with Bank of America and Goldman Sachs and Morgan Stanley converting to bank holding company registration, mandating a more conservative capital structure.

Beginning in mid-September, the federal government response to these developments has been significant. After some resistance, Congress approved the Treasury's Troubled Assets Relief Program (TARP). Although the funding was initially envisioned to support asset valuations, on October 14<sup>th</sup> the Treasury announced the Capital Purchase Program for banks and thrifts under the TARP, with clarification that the government's equity investment will rank equal with (and not rank senior to) existing DRD eligible preferred shareholders and junior to taxable preferred securities. This restored confidence in a preferred market that had been weakened significantly by the events beginning with the GSE conservatorship, and should facilitate the eventual restoration of private equity into these companies.

More recently, the Treasury announced a second round of preferred equity financing for Citigroup under the TARP, in addition to joining various other government agencies guaranteeing \$306 billion of this systemically important institution's troubled assets. In doing so, the Treasury returned to the original focus of the TARP – stabilizing asset valuations. Having committed the entire first tranche of TARP funding, the Treasury is now requesting the additional funds included in the initial legislation from Congress.

In consultation with Treasury, over the same period the Federal Reserve and the FDIC have established or announced a variety of funding facilities or guarantee programs to help stabilize financial markets, the magnitude of which dwarf the size of TARP. These include liquidity facilities for banks, primary dealers,

money market funds (using banks as intermediaries), commercial paper issuers and, most recently, asset-backed commercial paper issuers. Recent guarantee programs support intermediate bank debt issuers and money market funds. Announced for February 2009 are the Term Asset-backed Securities Loan Facility and the Government Sponsored Entities Purchase Program, to provide liquidity for consumer lending and to holders of GSE debt.

The speed and magnitude of the federal government's response to developments which climaxed in September have been unprecedented. While all issuers of preferred securities face a difficult operating environment over the next several years, this will be especially true for banks and other financial companies. However, the federal government's prompt recent actions provide some assurance that the financial system will continue to function.

### **Tax Advantages of 2008 Calendar Year Distributions**

In 2008, the Fund passed on a portion of its income to individuals in the form of qualified dividend income or QDI. QDI is taxed at a maximum 15% rate instead of an individual's ordinary income tax rate. In calendar year 2008, approximately 60.7% of distributions made by the Fund was eligible for QDI treatment. For an individual in the 28% tax bracket, this means that the Fund's total distributions will only be taxed at a blended 20.1% rate versus the 28% rate which would apply to distributions by a fund containing traditional corporate bonds. This tax advantage means that, all other things being equal, an individual in the 28% tax bracket who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$100 in distributions from a traditional corporate bond fund to net the same after-tax amount as the \$90 in distributions paid by the Fund.

For detailed information about the tax treatment of the particular distributions received from the Fund, please see the Form 1099 you receive from either the Fund or your broker.

Corporate shareholders also receive a federal tax benefit from the 55.2% of distributions that were eligible for the inter-corporate dividends received deduction or DRD.

It is important to remember that the composition of the portfolio and the income distributions can change from one year to the next, and that the QDI or DRD portions of next year's distributions may not be the same (or even similar) to this year's.

Pursuant to Rule 23c-1 under the Investment Company Act of 1940, the Fund is authorized to repurchase APS on the open market or through negotiated private transactions. Purchases of APS, if any, will be executed as market and business conditions warrant on the open market or in negotiated or block trades. The Fund is not obligated to repurchase any dollar amount or number of APS, and the timing and amount of any APS repurchased will depend on market conditions, share price, corporate and regulatory requirements, capital availability and other factors. Authorization to repurchase APS is at the discretion of the Fund's Board of Directors and may be limited or terminated at any time without prior notice.